

Nkonkobe Municipality

Audit Report

For the year ended 30 June 2014

**REPORT OF THE AUDITOR-GENERAL TO THE EASTERN CAPE PROVINCIAL
LEGISLATURE AND THE COUNCIL ON NKONKOBÉ LOCAL MUNICIPALITY
REPORT ON THE CONSOLIDATED AND SEPARATE FINANCIAL STATEMENTS**

Introduction

1. I have audited the consolidated and separate financial statements of the Nkonkobe Local Municipality set out on pages xx to xx, which comprise the consolidated and separate statement of financial position as at 30 June 2014, the consolidated and separate statement of financial performance, consolidated and separate statement of changes in net assets, consolidated and separate cash flow statement, and consolidated and separate statement of comparison of budget and actual amounts for the year then ended, as well as the notes, comprising a summary of significant accounting policies and other explanatory information.

Accounting officer's responsibility for the consolidated and separate financial statements

2. The accounting officer is responsible for the preparation and fair presentation of these consolidated and separate financial statements in accordance with South African Standards of Generally Recognised Accounting Practice (SA Standards of GRAP) and the requirements of the Municipal Finance Management Act of South Africa, 2003 (Act No. 56 of 2003) (MFMA) and the Division of Revenue Act of South Africa, 2013 (Act No. 2 of 2013) (DoRA), and for such internal control as the accounting officer determines is necessary to enable the preparation of consolidated and separate financial statements that are free from material misstatement, whether due to fraud or error.

Auditor-general's responsibility

3. My responsibility is to express an opinion on these consolidated and separate financial statements based on my audit. I conducted my audit in accordance with the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) (PAA), the general notice issued in terms thereof and International Standards on Auditing. Those standards require that I comply with ethical requirements, and plan and perform the audit to obtain reasonable assurance about whether the consolidated and separate financial statements are free from material misstatement.
4. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated and separate financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the consolidated and separate financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated and separate financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated and separate financial statements.
5. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my qualified audit opinion.

Basis for qualified opinion

Expenditure

6. Sufficient appropriate audit evidence was not submitted to substantiate general expenditure and repairs and maintenance expenditure in the consolidated and separate financial statements. I was unable to confirm this expenditure by alternative means. Consequently, I was unable to determine whether any adjustment were necessary to the general expenditure of R53,8 million disclosed in the consolidated and separate statement of financial performance and note 29, and the repairs and maintenance expenditure of R8,0 million disclosed in the consolidated and separate statement of financial performance and note 26 to the consolidated and separate financial statements.

Property, plant and equipment

8. Work-in-progress of R17,8 million (2013: R13,6 million) was included in the property, plant and equipment balance of R283,0 million (2013: R274,9 million) disclosed in the consolidated and separate statement of financial position and as disclosed in note 5. Due to inadequate record management, I was unable to obtain sufficient appropriate audit evidence that management had properly accounted for the work-in-progress included in disclosure note 5.1 to the consolidated and separate statement financial statements. I was unable to confirm the work-in-progress balance by alternative means. Consequently, I was unable to determine whether any adjustment was necessary to the work-in-progress stated at R17,8 million (2013: R13,6 million) in the consolidated and separate statement financial statements.

Receivables from exchange and non-exchange transactions

9. Sufficient appropriate audit evidence was not obtained to support receivables from exchange and non-exchange transactions disclosed in the consolidated and separate statement of financial position and note 2 and 3 to the consolidated and separate statement financial statements, due to inadequate record keeping. I was unable to confirm this balance by alternative means. Consequently, I was unable to determine whether any adjustment to the receivables from exchange transactions stated at R9,7 million (2013: R13,4 million) and trade receivables from non-exchange transactions stated at R29,1 million (2013: R21,3 million) in the consolidated and separate statement of financial position and note 2 and 3 to the consolidated and separate financial statements was necessary.

Non-current provisions

10. Sufficient appropriate audit evidence could not be obtained to confirm the data used in the calculations made in estimating the value of the obligation to rehabilitate landfill sites of R2,5 million (2013: R2,5 million) as disclosed in note 14 to the consolidated and separate financial statements. I was unable to confirm the provisions by alternative means. Consequently, I could not determine if any adjustments were necessary to the provision for the rehabilitation of landfill sites amounting to R2,5 million (2013: R2,5 million) as disclosed in the consolidated and separate statement of financial position.

Trade and other payables from exchange transactions

11. Trade payables and the related expenditure were overstated by R2,0 million as a result of the municipality not having adequate systems to identify and account for expenditure in accordance with GRAP 1 *Presentation of financial statements*.
12. Sufficient appropriate audit evidence could not be obtained due to poor records management for the items set out below:
- Amounts due for third party payments
 - Salary suspense accounts
 - Unallocated deposits
 - A listing of creditors
 - Payments received in advance

I was unable to confirm this balance by alternative means. Consequently, I could not determine if any adjustments were necessary to the trade and other payables amounting to R44,1 million (2013: R35,6 million) as disclosed in the consolidated and separate statement of financial position and note 8 to the consolidated and separate financial statements.

Prior period restatements

13. Sufficient appropriate audit evidence was not submitted to support the correction of errors in accordance with GRAP 3 *Accounting policies, changes in accounting estimates and errors* as disclosed in note 47 to the consolidated and separate financial statements. I was unable to determine whether any adjustments were necessary to the correction of errors disclosure note 47 and the accumulated surplus of R244,8 million (2013: R266,8 million) in the consolidated and separate statement of financial position.

Cash flow statement

14. Supporting evidence for the consolidated and separate cash flow statement was not provided and no alternative audit procedures were possible. Consequently, I was unable to determine whether any adjustments were required to the cash flows as disclosed in the cash flow statement and note 35 to the consolidated and separate financial statements.

Aggregation of immaterial uncorrected misstatements

15. The consolidated and separate financial statements as a whole were materially misstated due to the cumulative effect of numerous individually immaterial uncorrected misstatements in the following elements making up the consolidated and separate statement of financial performance and the notes to the financial statements:
- Revenue from exchange transactions was understated by R1,6 million.
 - Gains on fair value adjustments were overstated by R1,2 million
16. The consolidated and separate financial statements as a whole were materially misstated due to the cumulative effect of numerous individually immaterial uncorrected misstatements in the following elements making up the consolidated and separate statement of financial position and the notes to the consolidated and separate financial statements:

- Investment property was overstated by R632 590.
- Cash and bank was overstated by R598 500.
- VAT receivable is understated by R841 785.
- Non-current liabilities were understated by R587 700.

Qualified opinion

17. In my opinion, except for the effects of the matters described in the basis for qualified opinion paragraphs, the consolidated and separate financial statements present fairly, in all material respects, the consolidated and separate financial position of the Nkonkobe Local Municipality as at 30 June 2014 and its consolidated and separate financial performance and consolidated and separate cash flows for the year then ended, in accordance with SA Standards of GRAP and the requirements of the MFMA and DoRA.

Emphasis of matters

18. I draw attention to the matters below. My opinion is not modified in respect of these matters.

Restatement of corresponding figures

19. As disclosed in note 47 to the consolidated and separate financial statements, the corresponding figures for the financial year ended 30 June 2013 have been restated as a result of errors discovered during the 2014 financial year in the consolidated and separate financial statements of the municipality at, and for the year ended, 30 June 2014.

Material losses

20. As disclosed in note 46 to the consolidated and separate financial statements, the municipality incurred electricity distribution losses of R2,3 million (2013: R3,1 million) during the year.

Material impairment

21. Debt impairments of R23,2 million (2013: R8,2 million) as disclosed in note 25 to the consolidated and separate financial statements were made against exchange and non-exchange receivables.

Unauthorised expenditure

22. Unauthorised expenditure of R39,7 million, as disclosed in note 38.1 to the consolidated and separate financial statements, was incurred during the 2013/14 financial year due to overspending the budget, predominantly on employee costs (R17,8 million) and debt impairment (R19,6 million).

Irregular expenditure

23. Irregular expenditure of R3,8 million as disclosed in note 38.3 to the consolidated and separate financial statements was incurred during the 2013/14 financial year, as a result of supply chain management (SCM) procedures not having been followed.

Additional matters

24. I draw attention to the matters below. My opinion is not modified in respect of these matters.

Unaudited disclosure notes

25. In terms of section 125(2)(e) of the MFMA, the municipality is required to disclose particulars of non-compliance with this legislation. This disclosure requirement did not form part of the audit of the consolidated and separate financial statements and, accordingly, I do not express an opinion thereon.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

26. In accordance with the PAA and the general notice issued in terms thereof, I report the following findings on the reported performance information against predetermined objectives for selected development priorities presented in the annual performance report, non-compliance with legislation as well as internal control. The objective of my tests was to identify reportable findings as described under each subheading but not to gather evidence to express assurance on these matters. Accordingly, I do not express an opinion or conclusion on these matters.

Predetermined objectives

27. I performed procedures to obtain evidence about the usefulness and reliability of the reported performance information for the following selected development priorities presented in the annual performance report of the municipality for the year ended 30 June 2014:
- KPA 1: basic service delivery: engineering – roads, on pages xx to xx
 - KPA 1: basic service delivery: engineering – electricity, on pages xx to xx
 - KPA 1: basic service delivery: engineering – solid waste management, on pages xx to xx
 - KPA 1: basic service delivery: engineering – community facilities, on pages xx to xx
 - KPA 1: basic service delivery: strategic planning and LED – agriculture, on pages xx to xx
 - KPA 2: municipal transformation and organisational development – capacity building, on pages xx to xx
 - KPA 4: financial viability – capacity building, on pages xx to xx
28. I evaluated the reported performance information against the overall criteria of usefulness and reliability.
29. I evaluated the usefulness of the reported performance information to determine whether it was presented in accordance with the National Treasury's annual reporting principles and whether the reported performance was consistent with the planned programmes. I further performed tests to determine whether indicators and targets were well defined, verifiable, specific, measurable, time bound and relevant, as required by the National Treasury's *Framework for managing programme performance information* (FMPPI).
30. I assessed the reliability of the reported performance information to determine whether it was valid, accurate and complete.
31. The material findings in respect of the selected development priorities are as follows:

Roads, electricity, community facilities, solid waste management, agriculture and capacity building

Usefulness of reported performance information

Measurability of indicators and targets

32. The FMPPI requires the following:

- Performance targets must be specific in clearly identifying the nature and required level of performance. A total of 25% and 33% of the targets were not specific in relation to the electricity and agriculture objectives, respectively.
- Performance targets must be measurable. I was unable to measure the required performance for 25% and 33% of the targets in relation to the electricity and agriculture objectives, respectively.
- Performance indicators must be well defined by having clear data definitions so that data can be collected consistently and is easy to understand and use. Significantly important indicators in relation to electricity, roads, solid waste management, community facilities, agriculture and capacity building were not supported by technical indicator descriptions.
- Performance indicators or measures must be verifiable, meaning that it must be possible to validate the processes and systems that produced the indicator. A total of 25% of the indicators in relation to electricity and 33% of the indicators or measures in relation to agriculture were not verifiable.
- The measurability of the planned targets and indicators could not be assessed due to a lack of technical indicator descriptions, documented systems and processes as well as formal standard operating procedures for all development priorities selected for auditing.

This was because management was not aware of the requirements of the FMPPI, due to a lack of proper systems, processes and technical indicator descriptions.

Reliability of reported performance information

Roads

33. The FMPPI requires auditees to have appropriate systems to collect, collate, verify and store performance information to ensure valid, accurate and complete reporting of actual achievements against planned objectives, indicators and targets. Adequate and reliable corroborating evidence could not be provided for significantly important targets to assess the reliability of the reported performance information. The auditee's records did not permit the application of alternative audit procedures.

Additional matters

34. I draw attention to the following matters:

Achievement of planned targets

35. Refer to the annual performance report on pages xx to xx for information on the achievement of planned targets for the year. This information should be considered in the context of the material findings on the usefulness and reliability of the reported performance information for the selected development priorities reported in paragraphs 32 and 33 of this report.

Adjustment of material misstatements

36. I identified material misstatements in the annual performance report submitted for auditing on the reported performance information for all material development priorities (roads, electricity, community facilities, solid waste management, agriculture and capacity building). As management subsequently corrected only some of the misstatements, I raised material findings on the usefulness and reliability of the reported performance information.

Compliance with legislation

37. I performed procedures to obtain evidence that the municipality had complied with applicable legislation regarding financial matters, financial management and other related matters. My findings on material non-compliance with specific matters in key legislation, as set out in the general notice issued in terms of the PAA, are as follows:

Annual financial statements, performance report and annual report

38. The financial statements submitted for auditing were not prepared in all material respects in accordance with the requirements of section 122 of the MFMA. Some material misstatements of current assets, liabilities, revenue, expenditure and disclosure items identified by the auditors in the submitted financial statements were subsequently corrected, but the uncorrected material misstatements and supporting records that could not be provided resulted in the financial statements receiving a qualified audit opinion.

Budget

39. Expenditure was incurred in excess of the limits of the amounts provided for in the votes of the approved budget, in contravention of section 15 of the MFMA.

Revenue management

40. An effective system of internal control for debtors and revenue was not in place, as required by section 64(2)(f) of the MFMA.
41. Interest was not charged on all accounts in arrears, as required by section 64(2)(g) of the MFMA. The relevant exemption for not charging interest on this long-outstanding debt had not been granted by the council.

Expenditure management

42. Money owed by the municipality was not always paid within 30 days of receipt of an invoice or an agreed period, as required by section 65(2)(e) of the MFMA.
43. Reasonable steps were not taken to prevent unauthorised, irregular as well as fruitless and wasteful expenditure, as required by section 62(1)(d) of the MFMA.

Procurement

44. Awards were made to providers whose directors or principal shareholders are in the service of other state institutions, in contravention of section 112(j) of the MFMA and SCM regulation 44.

Consequence management

45. Unauthorised, irregular as well as fruitless and wasteful expenditure incurred by the municipality was not investigated to determine if any person is liable for the expenditure, as required by section 32(2)(a)(ii) of the MFMA.

Asset management

46. An effective system of internal control for assets (including an asset register) was not in place, as required by section 63(2)(c) of the MFMA.

Liability management

47. An effective system of internal control for liabilities (including a liability register) was not in place, as required by section 63(2)(c) of the MFMA.
48. Long-term debt was incurred without a resolution of the municipal council approving the debt agreement, in contravention of section 46(2)(a) of the MFMA.

Strategic planning and performance management

49. Key performance indicators, including input, output and outcome indicators in respect of selected development priorities and objectives, were not set out in the integrated development plan (IDP), as required by section 41(1)(a) of the Municipal Systems Act of South Africa, 2000 (Act No. 32 of 2000) (MSA) and municipal planning and performance management regulations (MPPMR) 1 and 9(1)(a).
50. Measurable performance targets for the financial year with regard to the electricity and agriculture objectives and key performance indicators were not set in the IDP, as required by section 41(1)(b) of the MSA and MPPMR 12(1) and 12(2)(e).
51. The performance management system and its related controls were inadequate, as it did not describe and represent the processes of performance planning, monitoring, measurement, review, reporting and improvement and how these were to be conducted, organised and managed, as required by section 38 of the MSA and MPPMR 7.

Audit committee

52. The audit committee was not constituted in the manner required by section 166(4)(a) of the MFMA, as there was no member with engineering skills and experience.
53. The performance audit committee did not submit, at least twice during the financial year, an audit report on the review of the performance management system to the council, as required by MPPMR 14(4)(a)(iii). Only one report was prepared and submitted for the period 1 July to December 2013.

Internal audit

54. The internal audit unit did not function as required by section 165(2) of the MFMA, in that it did not advise the accounting officer and/or report to the audit committee on matters relating to accounting procedures and practices as well as loss control.

Human resource management (HRM)

55. An acting chief financial officer was appointed for a period of more than three months during the 2013-14 year without the approval of the member of the executive council for local government, in contravention of sections 54A(2A) and 56(1)(c) of the MSA.

Internal control

56. I considered internal control relevant to my audit of the financial statements, annual performance report and compliance with legislation. The matters reported below are limited to the significant internal control deficiencies that resulted in the basis for the

qualified opinion, the findings on the annual performance report and the findings on non-compliance with legislation included in this report.

Leadership

57. Slow response to audit messages and effective leadership remain a challenge. The roles and responsibilities for recording and filing financial and performance information have been communicated to all relevant staff, but there is a lack of effective oversight by senior leadership to ensure accountability and adequate consequences for poor performance and transgressions, which resulted in repeat financial, performance information and compliance findings raised during the audit.
58. Oversight responsibilities regarding the monitoring of internal controls over financial reporting and compliance with applicable laws and regulations were not adequately performed. This resulted in the qualified audit opinion, non compliance with applicable laws and regulations and the information presented in the report on predetermined objectives not being valid, accurate and complete.
59. The leadership did not implement adequate controls to ensure that the financial statements submitted for auditing did not contain material errors and non compliance with applicable legislation. Although the municipality had developed an audit action plan, it was not adequately monitored by the leadership to ensure that management addressed internal control deficiencies.

Financial and performance management

60. The financial statements were subject to material adjustments that were not detected by management. In addition, there were material misstatements that were not corrected which form the basis of the qualified audit opinion. This is due to adequate daily and monthly financial processing and reconciliations not always taking place prior to the preparation of the financial statements, and the audit process was utilised to correct the financial records.
61. The municipality did not have a proper system of record management that provided for the maintenance of information to be reported in the annual performance report. This includes information that relates to the collection, collation, verification, storing and reporting of actual performance information.
62. The municipality's compliance monitoring process was not effective in the implementation and monitoring of controls to ensure that non-compliance with its laws and regulations was prevented or detected. This contributed to repeat non-compliance findings in the current year.

Governance

63. The municipality had an audit committee and internal audit unit. The recommendations of the audit committee and internal audit unit were not adequately addressed by management and therefore did not have a positive impact on addressing control deficiencies that existed in the municipality's control environment.
64. The audit committee was not fully effective in strengthening the control environment within the municipality, as numerous material misstatements were identified during the audit. Furthermore, recurring findings on performance reporting and compliance matters were identified during the audit process.

OTHER REPORTS

Investigations

65. Municipal officials were suspended after year-end for allegedly conducting acts of dishonesty and fraud in the municipality during the financial year. These acts included bypassing, tampering and illegally connecting electricity in the Fort Beaufort area of the municipality. The matter is currently under investigation by a member of the municipality. On finalisation of the investigation, relevant charges will be formulated against the implicated individuals and disciplinary action will be instituted.

Auditor General

East London

19 December 2014



AUDITOR - GENERAL
SOUTH AFRICA

Auditing to build public confidence